Brokerage Research Digest

February 4, 2013

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Google Inc.	(GOOG - NASDAQ)	$755.69*

Note: This report contains substantially new material. Subsequent reports will have new or revised material highlighted.

Reason for Report: 4Q12 Earnings Update

Prev. Ed.: November 27, 2012; 3Q12 Earnings Update (brokers' material are as of October 24)

Brokers' Recommendations: Positive: 83.3% (25 analysts); Neutral: 16.7% (5); Negative: 0.0% **Prev. Ed.:** 27; 5; 0

Brokers' Target Price: $827.75 (↑ $27.99 from last edition; 24 analysts) **Brokers' Avg. Expected Return:** 9.5%

***Note:** Although dated February 4, 2013, share price and broker material are as of January 31, 2013.

Note: A flash update was done on January 22, 2013 (4Q12 Earnings Update)

Note: The tables below (Revenue, Margins, and Earnings per Share) contain material from fewer brokers than in the Valuation table. The extra figures in the Valuation table are taken from reports that did not have accompanying spreadsheet models.

Portfolio Manager Executive Summary

Google Inc. (GOOG) is a technology company that maintains an index of websites and other online content for users, advertisers, Google network members, and several content providers. The company's solutions provide targeted advertising and Internet search solutions, as well as intranet solutions via an enterprise search appliance.

Key factors for evaluating an investment strategy in Google are as follows:

- Google is one of the best players promoting secular growth in Internet advertising.
- Google's net revenue is materially larger than that of Yahoo! (YHOO) and eBay Inc. (EBAY).
- Google generates revenue by delivering relevant, cost-effective online advertising and appears increasingly headed toward an opex leverage tipping point.

Competition: Competition between the leading Internet portals and search providers has increased with the significant growth in Internet advertising. Google's main competitors are Yahoo! and Microsoft. Google maintains the strongest position in the fastest growing segment of Internet search advertising. However, Yahoo! has an advantage in content, which may benefit it if other forms of Internet advertising catch up with search, as high speed Internet-enabled content gains greater audiences. Microsoft (MSFT) continues to have enormous potential, given its financial and strategic resources. Microsoft has been increasing its Internet presence, which has intensified the overall competition. Any market share taken up by its peers in search is likely to come primarily from Google, given that it is the largest player.

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Analysts' Opinions: Of the 30 analysts in the Digest group covering GOOG, 83.3% were positive and the remaining 16.7% were neutral. The Zacks Digest target prices range from a low of $765.00 to a high of $910.00, with the average being $827.75. On average, the brokerage analysts expect a return of 9.5% from the stock at the current share price.

Bullish Stance (Positive or equivalent ratings) – 25 analysts or 83.3%: The analysts remain bullish on the company's competitive products, increased operating leverage, acquisition strategy, and exceptional growth. They believe that the expanded product portfolio will make Google an attractive partner for publishers who monetize their sites primarily through display advertising. These analysts contend that Google will continue to capture market share and drive revenue growth in its core search business, while investing aggressively in new growth opportunities such as display, mobile, traditional media, and video offline media monetization. In addition, they believe that Google's industry-leading, pay-for-performance model will continue to support its growth in international markets. The analysts see significant opportunities for Google in the mobile and local advertising spaces going forward. Moreover, most of them believe that Google remains undervalued and relatively cheap for long-term investors.

Cautious Stance (Neutral or equivalent ratings) – 5 analysts or 13.3%: Though the analysts believe Google is the undisputed leader in its core business and remains well positioned to benefit from secular growth, they prefer to maintain a cautious stance until there is evidence of consistent profitability. The analysts expect margins to contract due to higher operating expenses and investments in new product development over the near term. These analysts prefer to wait until the traffic acquisition cost (TAC) rates, revenue trends, and operating leverage improves.

General Outlook

Google is the primary beneficiary of the rapid growth in Internet advertising, with a revenue growth rate that is twice its competitors. The company will continue to find new ways to make information readily available and these innovations will likely create value over time. The launch of new products (related to local search, personalization, core Web search expansion or any other ongoing service developments) will likely differentiate Google from its peers and drive growth going forward.

Overview

Google Inc. (GOOG), based in Mountain View, California, offers highly targeted advertising solutions, global Internet search solutions through its own site, and intranet solutions via an enterprise search appliance. By providing a freely available, online index of websites and other material, its proprietary automated search technology helps to access relevant information from the vast arena of the Internet. Google generates revenue by delivering relevant, cost-effective online advertising, and reselling business keyword access to promote its products and services with targeted advertising (beginning with ***AdWords*** in 2002 and ***AdSense for Content*** in 4Q04). Its clients include advertisers, content publishers, and site managers looking for cost-effective advertising. Google constantly adds new services to enhance its wide range of revenue generating search capability with features such as maps, photographs, email, and blogs. The company completed its IPO, partially through an innovative Web auction process in August 2004. More information is available at www.google.com.

The analysts have identified the following factors for evaluating the investment merits of GOOG:

Key Positive Arguments	Key Negative Arguments
• **Market Leader –** Technology-based innovations and new product launches have made Google a market leader. • **Ramp-up in Partnerships –** Google renewed its search agreements with EarthLink, Comcast, NTT, Nextag, and Tencent, and signed new deals with Sony Ericsson, Vodafone, SingTel, Washingtonpost.com, Clear Channel, Samsung, and China Mobile. • **Continued Innovation –** Google introduced several new innovative client applications to address consumer needs. • **Share Gains –** The analysts find the traffic growth rate of Google significantly higher than its competitors, which is expected to positively impact Google's assets such as content verticals, social networking sites, eCommerce listings, and mobile software.	• **Revenue Concentration –** Google's dominant share of search revenue has left it with a single-source revenue model. The change in advertising trend increases the volatility in search revenue. • **Click Fraud –** With hackers and spammers finding new ways to defraud Cost-Per-Click (CPC) advertisers, click fraud remains an issue. • **Margin Pressures –** As Google continues to grow and evolve, the investment required to build and promote new products may pressure margins. • **Competition –** Both Yahoo and Microsoft's MSN divisions offer fierce competition to GOOG in the search business. • **Disproportionate Voting Rights –** Class A shares carry only one vote per share, while Class B shares have 10 votes. Class B holders, including founders and executives, control 83% of voting power.

Note: GOOG's fiscal year ends on December 31.

Long-Term Growth

The development of global Internet advertising and eCommerce markets will be a substantial driver of Google's growth, but could present some incremental risk and downside opportunity (or volatility) as the company expands into markets that are more challenging or involve higher levels of entry risk and costs.

Google is the market leader in Internet advertising, which is expected to grow more than 20% over the next several years. Internet penetration of ad spending is approximately 13% worldwide. This is far short of Internet media consumption, measured at approximately 25%. According to analysts, this points to strong secular growth over the next several years.

The analysts believe that the company will continue to grow strongly in future. The analysts also believe that with a strong market share, Google is poised to become the *de facto* Internet search provider. Strong market entries such as China and Brazil heighten the potential for international growth.

The analysts also note that with Google's success, its competitors have begun to build effective competition within its operating environment. However, Google has a 'first mover' advantage that is not likely to erode easily. Given the increased competition, Google's efforts to improve its user experience through launches of new products (related to local search, personalization, core Web search expansion or any other ongoing service developments) will likely serve to differentiate Google and drive growth, going forward.

Secular growth drivers include rising broadband and wireless access, accelerating share shift from offline to online advertising, and growth in e-commerce. Google is also expected to benefit from market share gains in Europe and North America, strengthening demand for branded online advertising, global expansion, and the realization among advertisers that online advertising is the most cost-effective

medium. Meanwhile, growth in consumer generated media and emergence of video and rich media consumption create inventory and new monetization opportunities. In addition to monetizing content through advertising, there are many untapped opportunities for Google to monetize content by offering premium services, download or rental consumption or via subscription, and/or file sharing. The analysts stated that longer term, Google will be able to sustain its strong growth levels by leveraging its monetization engine against traffic from channels like MySpace and YouTube; new platforms, such as mobile; and display advertising through DoubleClick.

Target Price/Valuation

Provided below is a summary of valuation and rating as compiled by Zacks Digest Research:

Rating Distribution	
Positive	83.3%↓
Neutral	16.7%↑
Negative	0.0%
Average Target Price	$827.75↑
Digest High	$910.00
Digest Low	$765.00↑
Analysts with Target Price/Total	24/30

Risks associated with the achievement of the price target include intensifying competition that could limit GOOG's ability to drive long-term growth and profitability, deterioration in global economies that is slowing the secular shift to online advertising, any acquisition that is dilutive or not well received by the investors, loss of partnerships, and a slowdown in paid search.

Recent Events

On **Jan 22, 2013**, Google announced its 4Q12 results. Highlights are as follows:

- Total gross revenue increased 36.2% year over year and 2.3% sequentially to $14.4 billion.
- Total traffic acquisition cost (the portion of revenue shared with Google's partners) was $3.08 billion.
- GAAP EPS was $8.62 versus $8.22 in 4Q11.
- Non-GAAP EPS was $10.65 versus $9.50 in 4Q11.

On **Nov 19, 2012,** Google announced a licensing deal with several European music publishers, thus expanding the archive on Google Music. The Internet search giant collaborated with Armonia, a major European music publishing group which includes French, Italian and Spanish licensing groups.

The deal will provide Google users access to 5.5 million tracks on Google Music across 35 countries, including tracks by leading artists like Lady Gaga and Rihanna.

Revenues

According to the press release, gross revenue (including TAC) touched a record $14.4 billion, representing sequential and year-over-year increases of 2.3% and 36.2%, respectively. Excluding the $1.5 billion contribution from Motorola, revenues were up 21.9% from the year-ago quarter.

Google is very strongly positioned in the mobile segment, where smartphones and tablets have been making strong headway. This dominant position has enabled Google to generate very strong mobile revenue growth. In fact, the company's position in mobile looks better than it was on traditional computers, which says something about its strategic planning and execution.

Additionally, Google continues to benefit from the secular shift in advertising spending from offline to online properties, increasing contribution from medium and small-sized advertisers, success of the DoubleClick ad exchange, improving search algorithms and better ad quality.

Total revenue excluding total traffic acquisition costs came in at $11.3 billion, 8.3% lower than our estimated $12.4 billion.

Provided below is a summary of revenue as compiled by Zacks Research Digest:

Revenue ($ in million)	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Zacks Consensus				$12,260.0			$51,828.0	$57,024.0
Digest Average	$10,584.0	$14,028.7	$14,419.0	$14,166.0↓	$37,905.0	$51,165.5	$60,847.3↓	$70,013.8↓
Digest High	$8,134.0	$11,335.0	$11,345.0	$11,527.0↓	$29,099.0	$40,434.0	$50,268.0↓	$61,475.0↓
Digest Low	$8,131.0	$10,534.0	$11,339.0	$10,449.0↓	$29,092.0	$39,222.6	$46,437.1↑	$51,750.0↑
Y/Y Growth	*27.7%*	*49.9%*	*39.5%*	*37.7%*↓	*32.2%*	*38.2%*	*19.2%*↓	*15.8%*↓
Q/Q Growth	*8.3%*	*17.4%*	*0.8%*	*-1.2%*↓				

TAC – As reported by the company, traffic acquisition costs (TAC), the portion of revenue shared with Google's partners, increased to approximately $3.08 billion in 4Q12 from $2.45 billion in 4Q11. As a percentage of advertising revenue, TAC was 25.0% in 4Q12. The majority of the TAC expense was related to amounts paid to Network members, which totaled $2.44 billion in 4Q12. Besides, included in TAC are amounts paid to certain distribution partners and others directing traffic to the website, which totaled $634.0 million in 4Q12.

Paid Clicks – Aggregate paid clicks, which include clicks related to ads served on Google sites and the sites of AdSense partners, increased approximately 24.0% year over year and 9.0% sequentially. The acceleration was driven by the secular shift to online advertising, incremental mobile clicks and several search enhancements.

Cost-Per-Click (CPC) – Average cost-per-click, which includes clicks related to ads served on Google sites and the sites of Network members, was down 6.0% year over year but was up 2.0% sequentially. The year-over-year decrease in CPC was due to negative currency movements, mix of revenue from emerging markets and continued effects from ad quality changes.

Revenue Breakdown by Segments

Google Sites Revenue: As per the press release, Google-owned sites generated revenues of $8.64 billion or 67% of total 4Q12 revenues, up 18% year over year.

Google Network Revenue: Segment revenue in 4Q12 was $3.44 billion or 27% of total revenue, up 19% year over year.

Licensing and other fees: Licensing and other fees brought in 6% of revenues in the last quarter, up 102.0% year over year.

The **Hardware and Other segment** (formed in the Jun quarter and comprising mainly Motorola and Nexus 7) accounted for more than 10% of revenues in the fourth quarter. The 14.8% sequential decline was due to the sale of the home business, which the company treated as discontinued operations in the quarter.

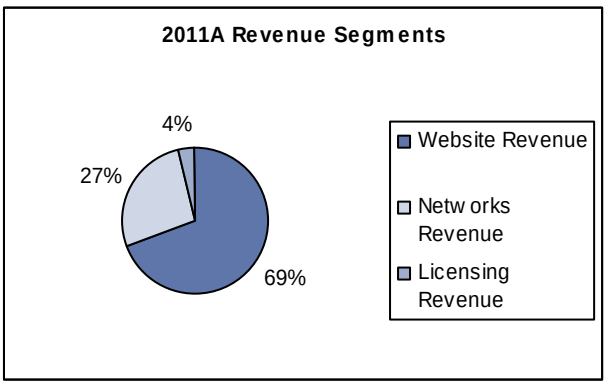
International Revenues

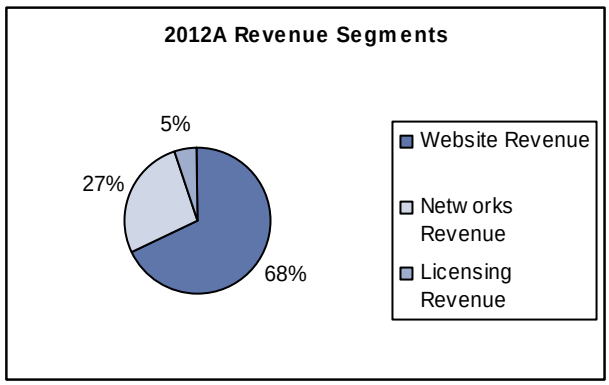
The U.S. generated around 46% of Google's standalone revenues, up 10.6% sequentially and 20.3% from a year ago. The U.K., with a 10% revenue share was up 7.3% sequentially and 22.7% from last year. Other international markets accounted for the remaining 44% of revenue, representing sequential and year-over-year increases of 14.6% and 23.5%, respectively. Motorola derives more than half its revenue from the U.S. and has a limited presence in the U.K. Both the U.S. and other international markets were impacted by the decline in Motorola revenues in the fourth quarter.

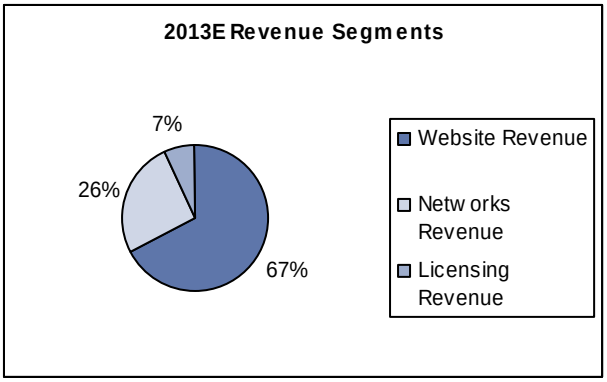
Provided below is a summary of segmental revenue as compiled by Zacks Research Digest:

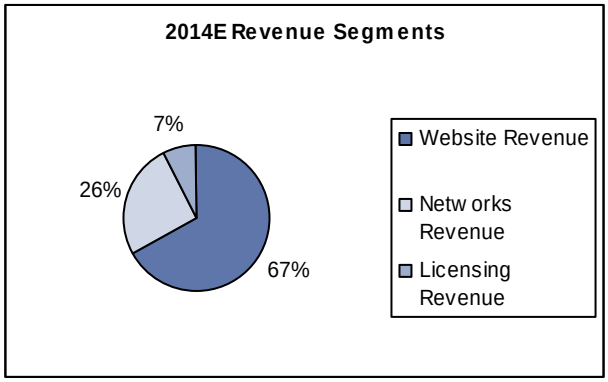
Segment Revenue ($ in million)	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Website Revenue	$7,294.0	$7,727.0	$8,640.0	$8,724.2↑	$26,145.0	$31,221.0	$36,963.4↑	$42,850.7↑
Networks Revenue	$2,880.0	$3,133.0	$3,436.0	$3,434.4↓	$10,386.2	$12,465.0	$14,570.2↓	$16,619.4↓
Licensing Revenue	$410.0	$666.0	$829.0	$733.4↓	$1,373.8	$2,354.0	$3,599.9↑	$4,678.2↑

The graphical representation of segmental revenue is given below:









Outlook

Google has a policy of not providing any financial guidance, given management's large personal holdings and its volatile business environment.

The analysts believe that newer growth businesses (Android, YouTube, Chrome, Social, Enterprise, Commerce, and Local) will continue to see strong trends.

The majority of the analysts believe that Google's position in mobile looks better than it was in traditional computing. Though they contend that revenue in the near term is likely to remain choppy based on the still early stages of mobile advertising, the analysts expect Google to benefit longer term as mobile search volume becomes more incremental and mobile CPCs increase over time.

Additionally, the analysts believe that the small and medium business (SMB) segment has played a key role in elevating Google's position in display. The analysts contend that Google's success in display is encouraging as display advertising is expected to grow strongly over the next few years, surpassing search advertising by 2015.

The analysts remain encouraged by the strong paid click growth in the fourth quarter and expect growth to continue going forward due to new ad formats and strength in mobile. They also believe that cost per click (CPC) rates will improve in the near future.

Please refer to the Zacks Research Digest spreadsheet on GOOG for more detail on revenue estimates.

Margins

According to the press release, **gross margin** of 56.9% declined 811 bps from the year-ago quarter but expanded 339 bps on a sequential basis. The decline in Motorola revenue share resulted in a positive mix, which helped the sequential comparison in the last quarter. However, the absence of any Motorola revenue in the year-ago quarter had a negative impact on the year-over-year comparison. The standalone Google gross margin was 61.5% (up 6 bps sequentially) compared to standalone Motorola's 17.4% (down 47 bps sequentially). The advertising gross margin was the combined effect of revenue growth, a 9% sequential (24% year-over-year) increase in the number of paid clicks, and a 2% sequential increase (6% year-over-year decline) in cost per click.

The number of paid clicks and cost per clicks appear significant, as they are indicative of higher volumes coming at lower prices. The mobile and emerging markets businesses are growing strongly and distribution costs are increasing, which could be the reasons.

Other costs, associated with data center operation, amortization of intangible assets, content acquisition, credit card processing and manufacturing and inventory-related costs increased significantly as a percentage of sales, which also negatively impacted gross margin in the quarter.

Operating expenses of $4.81 billion were flat sequentially and up 42.6% from the December quarter of 2011. **Selling and management (S&M) expenses** were $1,751.0 million in 4Q12 versus $1,268.0 million in 4Q11. **General and administrative (G&A) expenses** were $1,126.0 million in 4Q12 versus $809.0 million in 4Q11. **Research and development (R&D) expense** was $1,935.0 million in 4Q12 versus $1,298.0 million in 4Q11.

The **operating margin** was 23.5%, again impacted by higher hardware-related costs. All except G&A costs declined sequentially as a percentage of sales although all costs were up from the year-ago quarter.

GAAP net income was $2.89 billion in 4Q12 versus $2.71 billion in 4Q11 and **non-GAAP net income** was $3.57 billion compared with $3.13 billion in 4Q11.

Provided below is a summary of margins as compiled by Zacks Research Digest:

Margins	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Gross	65.8%	55.1%	57.9%	59.0%↑	65.9%	59.1%	58.8%↑	58.6%↑
Operating	38.2%	27.2%	29.4%	30.3%↑	37.5%	31.1%	30.5%↑	30.7%↑
Pre-Tax	38.0%	27.4%	29.7%	30.8%↑	39.0%	31.5%	31.0%↑	31.7%↑
Net	29.5%	21.4%	24.7%	25.0%↑	31.1%	25.9%	25.1%↑	25.3%↑

Outlook

The analysts believe that with bulk of Google's investments focused on strategic, high-growth opportunities where the company already has a leading position (e.g. Search, Android, YouTube, Display, and others), they are now less concerned about a rise in operational expenses. In addition, the company is trying to control its expenditure by closing projects that are not worth revenue generation.

Though the analysts expect near-term margins to be impacted by heavy investments in tablets, coupled with the exploding growth in mobile search, they believe that this is the right strategy for the company and will lead to higher-than-expected revenue growth in 2013 and beyond.

Please refer to the Zacks Research Digest spreadsheet on GOOG for more details on margin estimates.

Earnings per Share

According to the press release, pro forma EPS was $10.65 in 4Q12 versus $9.50 in 4Q11. The 4Q12 EPS figure was above the Street consensus of $10.61, aided by a lower tax rate and higher interest income.

GAAP EPS was $8.62 in 4Q12 versus $8.22 in 4Q11. The 4Q12 GAAP EPS includes stock-based compensation expense of $700 million and related tax benefits of $152 million.

Provided below is a summary of EPS as compiled by Zacks Research Digest:

EPS	4Q11A	3Q12A	4Q12A	1Q13E	2011A	2012A	2013E	2014E
Zacks Consensus				$8.76			$38.56	$44.42
Digest High	$9.50	$9.03	$10.65	$11.10↓	$36.08	$39.91	$47.25↓	$56.50↓
Digest Low	$9.48	$8.87	$10.65	$10.08↑	$36.04	$39.71	$42.63↑	$46.83↓
Digest Average	$9.50	$9.02	$10.65	$10.53↑	$36.06	$39.86	$45.21↓	$52.19↓
Y/Y Growth	*8.6%*	*-7.2%*	*12.1%*	*4.5%↓*	*21.8%*	*10.6%*	*13.4%↓*	*15.5%↓*
Q/Q Growth	*-2.3%*	*-10.9%*	*18.1%*	*-1.1%↓*				

Outlook

Most analysts believe higher revenue growth will drive earnings over the long term. Google is expected to benefit from higher display and mobile revenues, which would be mildly positive to overall pro forma EPS over the long term. However, some of the analysts believe that higher expenses may weigh on earnings growth over the long term.

Please refer to the Zacks Research Digest spreadsheet on GOOG for more details on EPS estimates.

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